

## Internal Revenue Service

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## LEGEND

X =

Trust  
1 =

Trust  
2 =

Trust  
3 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State  
1 =

State  
2 =

Year =

Dear \_\_\_\_\_ :

This letter responds to a letter dated December 9, 2009, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code.

#### FACTS

X was incorporated under the laws of State 1 on Date 1. X elected to be an S corporation effective Date 2. At that time, some of X's stock was held in Trusts 1, 2, and 3. Trusts 1, 2, and 3 were created under the laws of State 2 on Dates 3, 4, and 5, respectively. Trusts 1, 2, and 3 made elections to be qualified subchapter S trusts (QSSTs) effective Date 2. X acknowledges, however, that as of Date 2, Trusts 1, 2, and 3 did not meet the qualifications to be valid QSSTs for purposes of being S corporation shareholders. X represents that Trusts 1, 2, and 3 were eligible to be electing small business trusts (ESBTs) within the meaning of § 1361(e), but failed to make the required elections under § 1361(e)(3). Therefore, Trusts 1, 2, and 3 were ineligible shareholders, causing X's S corporation election to be invalid as of Date 2.

X and its shareholders represent that the circumstances surrounding X's ineffective S corporation election and the trustees' failure to timely file ESBT elections for Trusts 1, 2, and 3 were inadvertent and not motivated by tax avoidance or retroactive tax planning. For all taxable years, X reported income consistently with X qualifying as an S corporation. In addition, X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary with respect to the period specified by § 1362(f).

#### LAW

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible shareholder and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(v) provides that for purposes of § 1361(b)(1)(B), an ESBT is a permissible shareholder.

Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(B), the term “electing small business trust” means any trust if: (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2)-(5), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary; (ii) no interest in such trust was acquired by purchase; and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(3) provides that an election under § 1361(e) shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

Section 1362(f) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents; (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken (A) so that the corporation for which the election was made is a small business corporation, or (B) to acquire the required shareholder consents; and (4) the corporation for which the election was made, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in such ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides, in pertinent part, that, for purposes of § 1.1362-4(a), the determination of whether an invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the invalid election was inadvertent. The fact that the invalidity of the election was not reasonably within the control of the corporation or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the invalidity of the election was inadvertent.

Section 1.1362-4(d) provides, in pertinent part, that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an invalid election for an S corporation under § 1362(f), the

Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

### CONCLUSION

Based solely on the facts submitted and representations made, we conclude that X's S corporation election was ineffective beginning Date 2 because Trusts 1, 2, and 3 were ineligible shareholders. We also conclude that the ineffectiveness of X's S corporation election was inadvertent within the meaning of § 1362(f).

Under § 1362(f), X will be treated as continuing to be an S corporation on and after Date 2, unless X's S corporation election is otherwise terminated under § 1362(d), provided that the trustees of Trusts 1, 2, and 3 file ESBT elections with the appropriate service center within 60 days of the date of this letter to be effective Date 2. A copy of this letter should be attached to the ESBT elections. In addition, the trustees of Trusts 1, 2, and 3 must make appropriate adjustments, including filing amended tax returns if any are required, for the tax years ending after Year to bring Trusts 1, 2, and 3 in compliance with ESBT requirements.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed as to whether X otherwise meets the requirements to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Sincerely,

/s/

James A. Quinn  
Senior Counsel, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes

cc: